No. 16308

In the United States Court of Appeals for the Ninth Circuit

ESTATE OF MARY JANE LITTLE, Deceased, BANK OF AMERICA NATIONAL TRUST AND SAVINGS ASSOCIATION, *Executor*, PETITIONER

v.

COMMISSIONER OF INTERNAL REVENUE, RESPONDENT

On Petition for Review of the Decision of the Tax Court of the United States

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BRIEF FOR THE RESPONDENT

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OPINION BELOW

The opinion of the Tax Court (R. 27-43) is reported at 30 T.C. 936.

JURISDICTION

This petition for review (R. 45-47) involves federal income taxes for the years 1949 through 1952. The total deficiencies amount to $107,452.12. (R. 44.) On April 7, 1955, the Commissioner mailed to

the taxpayer notice of a deficiency in this total amount. (R. 10-15.) Within ninety days thereafter and on July 1, 1955 (R. 3), the taxpayer filed a petition with the Tax Court for a redetermination of that deficiency under the provisions of Section 6213 of the Internal Revenue Code of 1954 (R. 5-9). The decision of the Tax Court was entered on July 21, 1958. (R. 44.) The case is brought to this Court by a petition for review filed September 30, 1958. (R. 5, 45-47.) Jurisdiction is conferred on this Court by Section 7482 of the Internal Revenue Code of 1954.

QUESTION PRESENTED

Whether the Tax Court erred in holding that the taxpayer, a life income beneficiary of a trust, was not entitled to claim deductions for depreciation and depletion under Sections 23(l) and (m) of the Internal Revenue Code of 1939 with respect to oil and gas properties held as trust corpus, when under the terms of the trust under which she received the income, the amounts of the deductions were allocated to corpus.

STATUTE AND REGULATIONS INVOLVED

These may be found in the Appendix, *infra*.

STATEMENT

The facts were stipulated (R. 19-25) and were found accordingly (R. 28). As set out by the Tax Court, with certain additions supported by exhibits made a part of the record but not included by the Tax Court in its findings, they may be summarized as follows:

Mary Jane Little (referred to herein as the taxpayer) died on or about September 10, 1953, a resident of Los Angeles County, California. The Bank of America National Trust and Savings Association (referred to herein as the petitioner) is the duly appointed and acting executor of the estate of Mary Jane Little, deceased. (R. 28.)

The taxpayer was the mother of Gloria D. Foster, who died on or about July 30, 1943, a resident of Dallas County, Texas. For many years prior to her death Gloria conducted an oil business, owning, operating, developing and maintaining many producing oil and gas leases in the East Texas oil field. At the date of her death in 1943 she owned undivided interests in aproximately 84 producing oil wells in this field and in the physical equipment used in connection therewith. The oil income distributed to taxpayer as beneficiary of the Gloria D. Foster Trust during the years here involved (from which depletion and depreciation deductions here at issue were taken) was derived from these oil properties, or other subsequently acquired similar oil properties. (R. 29.)

The last will and testament of Gloria D. Foster, deceased, was duly probated by order of the County Court of Dallas County, Texas, on August 16, 1943. The will named L. C. Webster, Sol Goodell and T. A. Knight executors. After providing for a few specific bequests of cash and personal effects, the residue of Gloria's property was devised and bequeathed to L. C. Webster, T. A. Knight and Sol Goodell as trustees. The trust provisions of the will are contained in Article "V" and in this portion of the will the trustees

were given broad authority and discretion in connection with the management of the corpus, investment and reinvestments. Paragraph 2 of Article V of the will provided, in part, that the "decision of trustees as to what property is corpus and what property is income of [the] estate, shall be final and binding on all parties at interest hereunder. * * *" The will made no mention of the treatment of depletion and depreciation deduction as between income beneficiaries and the trust. (R. 29-30.)

Paragraphs 8 and 9 of Article V of the will provided as follows (R. 30-31):

> 8. Out of the net income of my estate I direct that Two Hundred ($200.00) Dollars per month shall be paid to my faithful servant, Eva Culbertson, during her lifetime, and One Hundred ($100.00) Dollars per month shall be paid to my mother-in-law, Mrs. Jeremiah Foster, during her lifetime and thereafter to my sister-in-law, Evelyn Foster, during her lifetime. All other net income from the estate shall be paid to my mother, Mary Jane Little, during her lifetime. If during any calendar year after the calendar year during which I die, while my mother is alive, the net income so paid my mother is less than Twelve Thousand ($12,000.00) Dollars, I direct that at the end thereof trustees pay to her the difference out of the corpus of my estate if she so requests.
>
> 9. This trust shall terminate on the date of the death of my mother, Mary Jane Little. On termination of this trust, I direct that all the estate and properties constituting it that are

then in the hands of trustees shall pass and vest in fees simple and by trustees shall be conveyed.

(a) one-half to Ann Armstrong Knight, if she then be living, and to her heirs per stirpes if she then be dead; and

(b) one-half to Marian Rolston Knight, if she then be living, and to her heirs per stirpes if she then be dead.

The trustees named in the will accepted the trust and allocated to the corpus of the trust so much of the income of the trust after operating expenses but prior to any deductions for depreciation and depletion allowable for federal income tax purposes with respect to such income. (R. 31.)

Taxpayer, Mary Jane Little, proposed to institute proceedings to contest Gloria's will dated April 19, 1943, relying upon the validity of a prior will dated September 8, 1942. For the purpose of settling the threatened will contest a contract and agreement, dated September 20, 1944, was entered into by and between the interested parties. The contract and agreement provided, in part, as follows: (a) that the purpose of the "contract and agreement is to settle, adjust and compromise all matters in issue or controversy between any and all of the parties here"; (b) that the trustees named under Gloria's will (dated April 19, 1943) were to resign as trustees, and others were to be appointed; (c) a trust agreement was to be entered into by all beneficiaries under the will, with changes in the power and duties of the new trustees, and with changes in the rights of the beneficiaries. (R. 31.)

Under Section II, heading 16 of the Contract and Agreement, the parties confirmed and agreed to the validity of the will dated April 19, 1943, "Subject to the conditions being met that are set out under headings 2, 3, and 5 above". Those conditions were that a declaratory judgment be obtained that the bequests to Ann Armstrong Knight and Marian Ralston Knight were not subject to the spendthrift trust provisions of the will, that the trustees resign and Mercantile National Bank at Dallas be the sole successor trustee, and that a new trust agreement be entered into, which provided that one-half the remainder go to the heirs of the taxpayer. (Ex. 6-F.)

Under heading 6 of this Contract and Agreement the remaindermen were to convey their interests to the Mercantile National Bank; the latter was to become the sole successor trustee. (Ex. 6-F.)

The trust agreement was executed by all the beneficiaries under date of November 14, 1944, and the old trustees resigned and were succeeded by the Mercantile National Bank at Dallas. Instead of the broad powers of disposition under the trust created by the will, the new trustee (with specified exceptions) could not encumber or dispose of properties constituting corpus of the trust without the consent of the beneficiaries. In place of the former broad powers of reinvestment, the trustee under the new trust agreement was limited to investments in United States Government bonds, unless consent to invest otherwise was given by the beneficiaries. As contrasted with the broad discretion to determine "what portion of receipts of the estate shall be allocated to

corpus of the estate, and what portion of such receipts shall be allocated to income of the estate" granted to the trustees under the will, the new trustee under the trust agreement was "to make this allocation at all times in accordance with the provisions of law applicable at the time without regard to such discretion so granted by said will". (R. 31-32.)

The foregoing, concerning the administration of the trust under the will of Gloria D. Foster, is set out in Section I of the Trust Agreement. Section II provides for a trust to be known as the Foster Trust, to be effective upon the death of the taxpayer and the termination of the trust under the will. The trust agreement contains provisions for the administration and termination of this second trust and for distribution of its corpus. (Ex. 7-G.)

On September 30, 1947, a suit was brought in the District Court of Dallas County, Texas, by L. C. Webster, Sol Goodell and T. A. Knight, as independent executors of the Estate of Gloria D. Foster, deceased, against Mercantile National Bank at Dallas, as successor trustee of the Estate of Gloria D. Foster, deceased; Mary Jane Little, deceased, the taxpayer; Talbot Shelton and Wharton E. Weems, as owners of one-half of the remainder interest in the estate; J. R. Bower, Jr., Ann Knight Bower, Frederick E. Rowe, Jr., and Marian Knight Rowe, as owners of the other half of the remainder interest in the estate. In their petition the plaintiffs alleged that during the course of their administration they, as executors, had received proceeds from the sale of oil and gas from

properties of the estate up to December 1, 1946, at which date the Mercantile National Bank at Dallas commenced collecting such proceeds; that they, as executors, had allocated to the corpus of the estate amounts representing "cost" depletion on oil produced and sold, together with depreciation on facilities, equipment, furniture, fixtures and the like, in accordance with practices employed by decedent, Gloria D. Foster, during her lifetime; that they, as executors, set forth such allocations of proceeds to corpus in their final account filed with the court, and they prayed that the court construe the will, particularly with reference to the meaning of the term "net income" as used therein, so as to approve their final account and to instruct them respecting the matter of what portion of funds in their hands represented net income and what portion was corpus and to discharge them from further liability and responsibility as executors. (R. 32-33.)

In their answer the defendants, Ann Knight Bower, J. R. Bower, Jr., Marian Knight Rowe and Frederick E. Rowe, Jr., interposed a cross action wherein they alleged that the issue of proper allocation of the proceeds of sale of oil and gas between income and corpus after December 1, 1946, by Mercantile National Bank at Dallas, trustee, was also in controversy as between themselves and Mary Jane Little and her assignees. The cross complainants requested declaratory relief to the effect that the Mercantile National Bank at Dallas, trustee, be ordered to compute and allocate to corpus depletion based on cost or 27½ per cent, whichever was greater, plus depreciation

based on the methods used by decedent, Gloria D. Foster, during her lifetime. (R. 33-34.)

Paragraph 11 of the taxpayer's answer in that proceeding (Ex. 8-H(6)) contained the following:

11.

This defendant denies the allegations contained in Paragraph 11 of plaintiffs' petition and in respect of the several corresponding subparagraph thereof alleges as follows:

(a) Plaintiffs, as executors, in the exercise of their alleged discretion, have retained, as corpus from the proceeds of the sale of oil and gas an amount equivalent to depletion computed on a cost basis as shown in their Exhibit B. This defendant, however, alleges that neither the will not the settlement agreement nor any of the exhibits mentioned therein contains any pertinent provision with respect to depletion, and that plaintiffs, as executors, were not vested with any discretion in respect of depletion or the apportionment of the proceeds of the sale of oil and gas between income and corpus, but instead were at all times bound to apportion such proceeds between income and corpus in accordance with the provisions of the Texas Trust Act applicable at the time, so that prior to April 11, 1945, they were required to apportion to corpus out of the net proceeds of the sale of oil and gas, after payment of expenses and carrying charges on such property, an amount equivalent to the amount permitted to be deducted for depletion under the then

existing laws of the United States of America for Federal income tax purposes, and after April 11, 1945, were required to apportion to corpus twenty-seven and one-half (27½) per cent of the gross proceeds from the sale of oil and gas (but not to exceed fifty (50%) per cent of the net, after deducting the expense and carrying charges on the property).

(b) Plaintiffs, as executors, were not entitled at any time to charge against income and to deduct therefrom, any amount for the depreciation of property used in the production of said oil and gas, because neither the will nor the settlement agreement nor any of the exhibits mentioned therein contains any pertinent provision with respect to depreciation, and that plaintiffs, as executors, were not vested with any discretion in respect of deducting depreciation or in the apportionment of the proceeds of the sale of oil and gas between income and corpus, but instead, the Texas Trust Act was at all times applicable and contained no provision authorizing any such deduction.

The court, by decision dated December 13, 1948, ordered, adjudged and decreed that L. C. Webster, Sol Goodell and T. A. Knight, as executors of the estate of Gloria D. Foster, deceased, had properly computed depletion and depreciation and allocated correct and proper amounts to corpus for depletion and depreciation as shown by their final account. (R. 33.) The court specifically found, in paragraph VIII of its decision, as follows (R. 34-35):

In determining the "net income" of decedent's estate defendant, Mercantile National Bank at Dallas, as Successor Trustee of the Estate of Gloria D. Foster, Deceased, in accordance with the law applicable to said estate at this time, and until otherwise directed by a court of competent jurisdiction, is authorized, required and directed to charge and set aside to corpus reserves for depreciation on oil and gas lease equipment and machinery, and depletion, in the following manner:

(a) Depreciation: A reserve for depreciation on the oil and gas lease equipment and machinery belonging to said estate, commencing December 27, 1946, to be computed in the same manner and according to the same formula as the decedent did during her lifetime and as plaintiffs have done as shown by their final account, which reserve for depreciation shall be deducted from the proceeds of sales of runs of oil and gas produced by said estate subsequent to December 1, 1946, and set aside to corpus.

(d) Depletion: Out of proceeds of oil and gas runs produced and sold and to be produced and sold from each oil and gas lease subsequent to December 1, 1946, compute, charge and set aside to corpus 27½% of the gross proceeds of such sales of runs from each lease (but not to exceed 50% of the net income from such lease after deucting the expense and carrying charges on such lease, including depreciation, but not including depletion).

Consistent with its judgment the court decreed that of the $43,091.91 in custody of the executors, $42,379.96 represented corpus of the estate of Gloria D. Foster, deceased, and $711.95 was net income of

the estate. The executors, having previously paid the former sum to Mercantile National Bank at Dallas, trustee, and the latter to the taxpayer, were discharged and acquitted of all other claims arising out of their administration. Taxpayer excepted to the judgment of December 13, 1948, in open court, and gave oral notice of appeal, but this appeal was not perfected by her and the judgment became final. (R. 35-36.)

Sproles & Woodward, certified public accountants, were the accountants who kept the books and records of Gloria D. Foster and prepared her income tax returns. These same accountants continued to keep the books and prepare the income tax returns of the Gloria D. Foster estate and trust after her death during the entire period here involved. The books of Gloria D. Foster, while living, regularly and consistently made a charge against income and set up a reserve for depletion of oil and gas properties and a reserve for depreciation of oil and gas equipment in accordance with standard accounting principles. Subsequent to her death, the estate and trust have regularly and consistently set aside to corpus a reserve for depletion of oil and gas properties and a reserve for depreciation of oil and gas equipment. Depletion was computed on the basis of "cost" (which was the practice of Gloria D. Foster while living) by the executors and trustees from August, 1943, to December, 1946, and thereafter the trust has used "percentage" depletion. Deductions for depletion and depreciation were claimed in the federal income tax returns, throughout, consistent with the books of

Gloria D. Foster, and, later, the books of her estate and trust. (R. 36.)

In filing income tax returns for the Gloria D. Foster Trust, for the years here involved, the trustees computed and claimed as deductions the full amounts of allowable depletion and depreciation. Mary Jane Little, deceased, in her income tax returns for the years here involved, claimed a share of the deductions for depletion and depreciation allowable in respect of income of the Gloria D. Foster Trust. Taxpayer claimed that she was entitled to deduct a portion of the total allowable deductions for depletion and depreciation based upon the proportion of the net income of the estate (prior to such deductions) which was allocable to her. (R. 36-38.)

The Tax Court sustained the Commissioner's determination that the entire amounts were deductible by the trustee. (R. 42-44.)

SUMMARY OF ARGUMENT

I

Under the contract of settlement and the trust agreement of 1944, all parties claiming an interest in the estate of Gloria D. Foster by agreement drastically modified the trust provided in her will, and also provided for a later trust to become effective upon the death of the taxpayer. The terms of this later trust are irrelevant to the issues here, which concern the tax treatment of the income received by the taxpayer during her lifetime.

The agreement of 1944 specifically directed that allocation of receipts to corpus or to income be made

"in accordance with the provisions of law applicable at the time without regard to" the discretion granted by the will. Under the Texas Trust Act, as construed by the Texas Court, reserves for depletion and depreciation were to be allocated to corpus.

In a noncollusive, adversary proceeding, after considering evidence and argument, and determining both the facts and the law, the appropriate Texas court construed the trust as requiring the allocation to corpus of reserves for depletion and depreciation prior to the distribution of income. Its decision as to the provisions of the trust is controlling here.

II

Section 23(l) and (m) of the Internal Revenue Code of 1939 provide that in the case of property held in trust the allowable deductions for depreciation and depletion shall be apportioned between the income beneficiaries and the trustee in accordance with the pertinent provisions of the instrument creating the trust.

The trust under which the property was held during the taxable years, and under the terms of which the income was paid to the taxpayer, was the "Foster will trust" modified by the trust agreement of 1944. The pertinent provisions of that instrument directed the allocation of the allowances to corpus.

The property was not held under the terms of the will, unmodified, nor did the taxpayer receive her taxable income under the original terms. Even if she had, however, those terms could be construed as carrying out an intent of the testatrix that the allow-

ances be allocated to corpus in the same manner. But the court below correctly held that "the trust" whose terms are to be considered was the modified trust.

ARGUMENT

I

The Texas Court's Decision Construing the Provisions of the Modified "Foster Will Trust" Was a Final Adjudication of the Rights of the Parties Thereunder and Is Controlling

The facts have been stipulated, and should not be in dispute. We are here concerned with the trust under the will of Gloria D. Foster, as modified by the contract and trust agreements in 1944.

However, the petitioner has introduced unnecessary confusion in the case by its emphasis on a later trust, not related to the years in controversy or to the tax issues here involved. The agreements under which the "Foster will trust" [1] was modified also provided for a later trust, to become effective upon the death of the taxpayer. This later trust is irrelevant to the present case, since it did not become effective during the taxable years involved, nor did its terms relate to the issues here. It is to this later trust that petitioner is referring when it states that the corpus of the testamentary trust was not transferred to the trustee under the agreement of September 20, 1944 (Br. 8), when it recites that the trustee was to hold naked legal title to the interests conveyed

[1] The term used in the opinion below. (R. 40.)

by the remaindermen prior to the death of the taxpayer (Br. 9-10), when it states that the agreement of 1944 did not supersede the testamentary trust "so as to cause the new trust to become the trust the deductions for which were to be apportioned" (Br. 19, 31), and when it recites, with apparent completeness, the provisions of the trust agreement (Br. 33-34).

For the sake of clarity, therefore, we summarize the facts relevant to the issue before this Court. The will of Gloria Foster gave the trustees discretion as to the management of the corpus, and also provided, in part, that the "decision of the trustees as to what property is corpus and what property is income of [the] estate, shall be final * * *." (R. 29.)[2] The taxpayer threatened to contest the will, and a contract and agreement was entered into in September, 1944, followed by a trust agreement in November, 1944, which created the new trust referred to above, and also modified the Foster will trust. (R. 31-32.) These agreements sharply limited the discretion of the trustees, removed the spendthrift provisions as to the remaindermen, and provided that the original trustees of the Foster will trust should resign and that Mercantile National Bank become the successor trustee. Heading 4 of Section I of the trust agreement of November, 1944 (Ex. 7-G) reads as follows:

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[2] The court below noted, but did not decide, that there is some question whether or not the will alone could be construed as requiring apportionment of depletion and depreciation to corpus. (R. 40, 43.)

> 4. The will grants to the Trustees thereunder broad discretion in determining what portion of receipts of the estate shall be allocated to corpus of the estate, and what portion of such receipts shall be allocated to income of the estate, and Third Party in the exercise of such discretion hereby undertakes to make this allocation at all times in accordance with the provisions of law applicable at the time without regard to such discretion so granted by said will. Subject to the foregoing, Third Party, while acting as Trustee under said will, shall pay the net income of said estate to Eva Culbertson, Mrs. Jeremiah Foster or Evelyn Foster, and to Second Party in accordance with and under the terms and provisions of Section V of said will.

Under Section II, heading 16 of the Contract and Agreement, the parties confirmed and agreed to the validity of the will "Subject to the conditions being met that are set out under headings 2, 3 and 5 above." (Ex. 6-F.)[3]

The original trustees had allocated to corpus depletion and depreciation, in accordance with the practices employed by Gloria D. Foster in her lifetime. In 1947 they brought suit in the District Court, Dallas County, Texas, naming as parties the successor trustee, the taxpayer, and the remaindermen, requesting the court to approve their account and to construe the will and instruct them, particularly with reference to what amounts constituted income and what corpus. (R. 33.) There was a contest between the remaindermen and taxpayer as to the

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[3] Petitioner's statement (Br. 8) omits this qualification.

amount which should be set aside to corpus as depletion and depreciation. Taxpayer's position was that the executors could not charge against income any amount for depreciation, and were required to apportion to corpus an amount equal to the depletion deduction pursuant to the provisions of the Texas Trust Act. (Ex. 8-H(6).)

The court's decision (Ex. 8-H(15)) recites that it had heard the pleadings, the evidence and argument, and was determining the facts as well as the law. It adjudged that the executors had properly computed and allocated depletion and depreciation, held that the amounts so allocated were corpus and should be turned over to the successor trustee and that taxpayer (par. IV) "is not entitled to any part of said sum," approved the final account, and directed (par. VIII) that the successor trustee "in accordance with the law applicable to said estate at this time, and until otherwise directed by a court of competent jurisdiction" should charge and set aside to corpus the reserves for depletion and depreciation.[4] Taxpayer's oral appeal from the decision was not perfected by her and the judgment became final. (R. 36.)

Petitioner argues that this court decision (1) was not a construction of the Foster will trust (Br. 37),

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[4] The pertinent provisions of law applicable at this time were embodied in the Texas Trust Act. General and Special Laws, Texas, 1943, c. 148, p. 232. As construed by the local court reserves for depletion and depreciation were to be allocated to corpus. See the Tax Court's opinion (R. 40-42) in this respect.

and (2) is in any event entitled to no weight (Br. 38).

Petitioner's arguments as to the first point appear to be that the agreement of 1944 was not intended to modify the testamentary trust as such, but was merely a collateral contract as to how the trustees should exercise their discretion to allocate trust receipts to income or corpus as they saw fit, and that the court was merely construing and enforcing this collateral contract. (Br. 37.) There is no support in the court's decision for any such distinction. So far as that decision indicates, the court was approving the actions of the plaintiffs and instructing the successor trustee under the terms of a single legal instrument incorporated in two documents, the will *as modified* by the 1944 agreement. Furthermore the argument that the 1944 agreement was no more than an incidental contract overlooks the fact that it drastically modified the original provisions of the Foster will trust, imposing severe limitations on the powers of the trustees, requiring the withdrawal of the trustees named in the will and designating another trustee, and cutting in half the interest of the remaindermen named in the will. It overlooks the fact that *only* as so modified was the validity of the will to be unchallenged. It is clear, therefore, that the parties to the agreement, including the taxpayer, and the Texas court regarded the 1944 agreement as an integral part of the terms of the Foster will trust.

As to petitioner's second argument, that the decision of the Texas court in construing the trust should be given no weight, we note first that there is no

suggestion that the decision was obtained by collusion, or by consent in a nonadversary proceeding, or was *pro forma*. There was a bona fide contest between adversary parties; the court's attention was directed to the specific contested question of the allocation of depreciation and depletion to corpus or to income; it heard evidence and argument; and it decided that question. It did not purport to determine the federal tax question; it did determine the terms and application of the Foster will trust.[5]

In so far as the first question involved is concerned—as to how under the trust the depletion and depreciation must be allocated, as concerns the parties to the trust—the Texas court decree is conclusive. *Freuler* v. *Helvering*, 291 U. S. 35, 44-47. The state court decree is binding "so far as it is found that local law is determinative of any material point in controversy." *Blair* v. *Commissioner*, 300 U. S. 5, 9. See also, *Gallagher* v. *Smith*, 223 F. 2d 218 (C. A. 3d). The state court decree is binding as to the meaning of the pertinent terms of the trust, particularly as to what are "the provisions of law applicable at the time" (R. 32, 34) with respect to how receipts shall be allocated between income and corpus.

With the state court decree conclusive as to the rights of the parties under the modified "Foster Will Trust," the federal question arises as to the tax consequences of the allocation. To that question we now turn.

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[5] Petitioner suggests (Br. 33) that there are possibilities of collusion to obtain tax avoidance if such agreements are approved, and that there are possibilities of abuse. This, however, is not such a case.

II

The Trust Under Which the Apportionment of Depreciation and Depletion Deductions Was Made and Under Which Income Was Paid To and Received By the Taxpayer as the Modified Trust Created By the Trust Agreement of 1944 and the Will

Both Section 23(l) of the Internal Revenue Code of 1939 (Appendix, *infra*), dealing with depreciation, and Section 23(m) (Appendix, *infra*), dealing with depletion contain the following provision:

> In the case of property held in trust the allowable deduction shall be apportioned between the income beneficiaries and the trustee in accordance with the pertinent provisions of the instrument creating the trust, or, in the absence of such provisions, on the basis of the trust income allocable to each.

This language first appeared in Section 23(k) and (l) of the Revenue Act of 1928, c. 852, 45 Stat. 791. Prior to that time, in situations where the trust instrument or local law did not require the setting aside of a reserve for depreciation or depletion, and the entire trust income was payable to the beneficiary, the latter did not receive the benefit of the allowance. The Senate Finance Committee report explained the effect of the new language as follows (S. Rep. No. 960, 70th Cong., 1st Sess. (1928), p. 20 (1939-1 Cum. Bull. (Part 2) 409, 423)):

> In the case of property held in trust, the allowable deduction is to be apportioned between the income beneficiaries and the trustee in accordance with the pertinent provisions of the will, deed, or other instrument creating the trust, or,

> in the absence of such provisions, on the basis of the trust income which is allocable to the trustee and the beneficiaries, respectively. For example, if the trust instrument provides that the income of the trust computed without regard to depreciation shall be distributed to a named beneficiary, such beneficiary will be entitled to the depreciation allowance to the exclusion of the trustee, while if the instrument provides that the trustee in determining the distributable income shall first make due allowance for keeping the trust corpus intact by retaining a reasonable amount of the current income for that purpose, the allowable deduction will be granted in full to the trustee. The bill contains similar provisions as to the reduction for depletion.

The language of the Conference Committee report is similar. H. Conference Rep. No. 1882, 70th Cong., 1st Sess. (1928) pp. 11-12 (1939-1 Cum. Bull. (Part 2) 444, 445). The applicable Treasury Regulations follow the language of these Committee Reports. Treasury Regulations 111, Sections 29.23(l)-1 and 29.23(m)-1; Treasury Regulations 118, Sections 39.23(l)-1 and 39.23(m)-1, Appendix, *infra*.

It is apparent that neither the Committee Reports nor the Regulations throw any direct light on the issue here, which is what is to be regarded as the trust instrument. Petitioner assumes throughout that the relevant trust is that originally created by the will of Gloria Foster, without subsequent modification, and accordingly discusses only the pertinent provisions of the instrument originally creating *that* trust. We submit, however, that "the trust" with which

the statute is concerned in this case is the *modified* trust arising from the trust agreement of 1944.

The statute is not limited to testamentary trusts. It applies to all trusts, however and whenever created. It is clearly intended to deal with whatever the trust may be under which the taxable income is received and the depletion and depreciation deductions are claimed. For the taxable years involved in the present case the income was received and allocations to income and corpus were made only under the modified trust arising out of the settlement and trust agreement of 1944.

To put it differently, although the petitioner argues as though there were but the original trust, analytically and chronologically there were three. The first was the trust provided in the will of Gloria Foster. The second was created in 1944, by agreement of all persons claiming an interest in the corpus.[6] This second, under which the income here taxed was paid and received, contained terms substantially different from those in the will, and the document confirmed the validity of the will only as so modified. The third trust, also created in 1944, was to become operative only on the death of the taxpayer.

Whether we consider the trust here in question as being a separate trust from the original one, or a modification of the original one, we cannot know what "the trust" was during the taxable years by looking at the will alone. The trust as set up by the will no longer existed in its original form. The

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[6] Their power to do so was implicitly upheld by the Texas court's decision.

property was no longer held subject to its terms. The statute refers to "the case of property held in trust." During the taxable years the property was held subject to the 1944 agreement, not subject to the will alone.

The "instrument creating" the trust with which we are concerned was primarily the trust agreement of 1944, plus those provisions of the will accepted by the settlement agreement. The "pertinent provisions" of the 1944 agreement can hardly be disputed; they provide for the allocation of depreciation and depletion to corpus. We need not go as far as the court in *Netcher* v. *Commissioner*, 143 F. 2d 484 (C. A. 7th), certiorari denied, 323 U. S. 759, or as both the majority and concurring judges in *Newbury* v. *United States*, 57 F. Supp. 168 (C. Cls.), certiorari denied, 323 U. S. 802, had to go to read into the instrument a direction to the trustee to maintain the corpus intact. In view of the explicit language of the trust agreement, as interpreted and enforced by the Texas court, there is no problem of construction of the trust instrument such as was present in those cases, and in *Fleming* v. *Commissioner*, 121 F. 2d 7 (C. A. 5th), and in *Fred A. Hubbard Apartments Trust* v. *Commissioner*, decided January 12, 1951 (1951 T.C. P-H Memorandum Decisions, par. 51,006).[7]

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[7] These latter two cases in fact are contrary to the petitioner's basic position, since they turn on the operation of the trusts during the taxable years in question rather than going back to the original intent of the settlor.

A problem of construction would be present if the payments to the taxpayer had been made under the original terms of the will, unmodified by the trust agreement of 1944. Even there, however, as pointed out by the court below (R. 42-43), there is a basis for finding that the intent of the testatrix was to set aside to corpus reserves for depletion and depreciation. So, even if we were to disregard the express terms of the trust in which the property was held and under which the taxpayer received her income, to look at the earlier, and obsolete, terms, they could be construed as requiring the same disposition of the allowances for depletion and depreciation.

CONCLUSION

For the foregoing reasons the decision of the court below should be affirmed.

Respectfully submitted,

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APPENDIX

Internal Revenue Code of 1939:

SEC. 23. DEDUCTIONS FROM GROSS INCOME.

* * * *

(l) *Depreciation.*—* * * In the case of property held in trust the allowable deduction shall be apportioned between the income beneficiaries and the trustee in accordance with the pertinent provisions of the instrument creating the trust, or, in the absence of such provisions, on the basis of the trust income allocable to each.

(m) *Depletion.*—* * * In the case of property held in trust the allowable deduction shall be apportioned between the income beneficiaries and the trustee in accordance with the pertinent provisions of the instrument creating the trust, or, in the absence of such provisions, on the basis of the trust income allocable to each.

* * * *

(26 U.S.C. 1952 ed., Sec. 23.)

Treasury Regulations 111, promulgated under the Internal Revenue Code of 1939:

Sec. 29.23(l)-1. *Depreciation.*—* * * In the case of property held in trust, the allowable deduction is to be apportioned between the income beneficiaries and the trustee in accordance with the pertinent provisions of the will, deed, or other instrument creating the trust, or, in the absence of such provisions, on the basis of the trust income which is allocable to the trustee and the beneficiaries, respectively. For example, if the trust instrument provides that the income of the trust computed without regard

to depreciation shall be distributed to a named beneficiary, such beneficiary will be entitled to the depreciation allowance to the exclusion of the trustee, while if the instrument provides that the trustee in determining the distributable income shall first make due allowance for keeping the trust corpus intact by retaining a reasonable amount of the current income for that purpose, the allowable deduction will be granted in full to the trustee. * * *

* * * *

Sec. 29.23(m)-1. *Depletion of Mines, Oil and Gas Wells, Other Natural Deposits and Timber; Depreciation of Improvements.*—* * *

* * * *

* * * The principles governing the apportionment of depreciation in the case of property held by one person for life with remainder to another person and in the case of property held in trust are also applicable to depletion. (See section 29.23(l)-1.)

* * * *

Sections 39.23(l)-1 and 39,23(m)-1 of Treasury Regulations 118, applicable to years beginning after December 31, 1951, contain identical language.

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